Nos. 760 and 781

In the Supreme Court of the United States

OCTOBER TERM, 1967

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
IRVING GORDON AND MARGARET GORDON

OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

REPLY BRIEF FOR THE COMMISSIONER

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I. THE DETAILED REQUIREMENTS OF SECTION 355 MUST BE APPLIED WITH PRECISION TO EFFECT THE CONGRESSIONAL PURPOSE OF INSURING AGAINST UNINTENDED USES OF DIVISIVE REORGANIZATIONS

Taxpayers' principal contention seems to be that, whatever the statute may say, Pacific's 1961 disposition of 57 percent of the Northwest stock should be ruled tax-free because "the result * * * was a spin-

off reorganization which Congress intended to be tax-free under Section 355" (Br. 29),[1] and Congress (Br. 34) "intended that the widest latitude be permitted in the forms and methods used in carrying out" divisive reorganizations. But, despite the taxpayers' broad sweep, this case turns on the detailed language of Section 355, which provides exceptional tax treatment for "a carefully and elaborately defined category of transactions", cf. *Braunstein* v. *Commissioner,* 374 U.S. 65, 71. As a comparison of Section 355 with the prior 1951 law shows, the 1954 provision is one of the "less liberal rules" that the 1954 Congress adopted "in order *to insure* that transactions which are in substance, although not in form, dividend distributions * * * are subject to tax at ordinary income rather than at capital gain rates * * *." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42 (emphasis supplied); see, also, H. Rep. No. 1337, 83d Cong., 2d Sess., p. 34. The present law must be interpreted and applied in a manner consistent with this general statement of congressional purpose.

Thus, it is not enough for the taxpayers to say that the transaction here was not one "used principally as a device for the distribution of earnings and profits * * *." See Section 355(a)(1)(B). There is more to the statute than this. It is concerned with means as well as ends. The detailed requirements that Section 355 imposes on the process of distribution, the continuation of businesses, and the amount of the stock distributed constitute the means Congress pre-

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[1] "Br." refers to taxpayers' opening brief in this Court.

scribed to limit the use of the spin-off. Each is more restrictive than the 1951 law,[2] and plainly designed "to insure," S. Rep. No. 1622, *supra,* p. 42, against unintended uses of corporate divisions.

The provisions of the statute on which we rely, Sections 355 (a)(1)(A) and 355(a)(1)(D), are detailed and specific. The less objective test of Section 355(a)(1)(B) is a supplementary safeguard, which excludes from tax-free treatment any transaction that comes within the letter of the other parts of Section 355, but nevertheless "principally" constitutes a tax-avoidance device.[3] Compare *Gregory* v. *Helvering,* 293 U.S. 465. A proper view of Section 355, then, means that Pacific's disposition of Northwest's stock must comply with the specific provisions of the statute. We turn to a further examination of the statute, and such contentions as taxpayers address to the language of Sections 355(a)(1)(A) and 355(a)(1)(D).[4]

[2] In Section 355(a)(1)(A), the phrase "with respect to its stock" replaced the more flexible clause "in pursuance of a plan of reorganization," see Section 355(a)(2)(C) of the 1954 Code and Section 112(b)(11) of the 1939 Code, and the word "solely" was added before "stock or securities." The requirement of Section 355(a)(1)(D) that at least 80 percent control be distributed eliminated the provision of the 1951 law, Section 112(g)(1)(D) of the 1939 Code, that allowed the post-spin-off control of the subsidiary to be shared by "both" the parent and its shareholders, a change that the 1954 Code did not apply to nondivisive reorganizations, see Sections 368(a)(1)(D) and 354(b)(1)(B). Compare Regs. § 39.112(b)(11)2(C) under the 1939 Code, which said that "*ordinarily* * * * all of the stock" of the subsidiary will be distributed. (Emphasis supplied.)

[3] The same analysis applies to taxpayers' reliance (Br. 36, 63) on the language of Section 355(a)(1)(D)(ii).

[4] Taxpayers in No. 760 concede (Br. 71) "that section 355 does not apply to the sale of the rights." They nevertheless

II. TAXPAYERS HAVE FAILED TO SHOW THAT PACIFIC'S TRANSACTION SATISFIES SECTION 355(a)(1)(A)

1. As we explain in detail in our opening brief, at pages 23–40, Pacific's sale of the Northwest stock for a substantial cash consideration to those holding rights could not be the distribution "to a shareholder, with respect to its stock" required by Section 355(a)(1)(A). In response, taxpayers ask (Br. 25, 36–37, 47–49), in essence, how the transaction can fail to qualify for tax-free treatment when it would have fallen within Section 355(a)(1)(A) if Pacific's shareholders had received all of the Northwest stock free of cash consideration, and had therefore received a greater value.

There is neither a paradox nor an anomaly in the fact that a greater distribution may be allowed more favorable tax treatment than a lesser one would receive, all other things being equal. For example, Section 346(a)(2) and 346(b) permit taxation at the more favorable capital-gains level for substantial distributions which represent a partial liquidation, *i.e.*, "a genuine contraction of the business" (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262; see, also, Treas. Reg.

maintain (Br. 71–72) that they should be taxed on the sale of rights as if it were a sale of stock received tax-free under Section 355, pointing, for analogy, to Section 1234(a), which provides that gain "attributable to the sale" of an option shall have the same character as gain on the sale of property to which the option relates. The answer to this contention is seen in *Gibson* v. *Commissioner*, 133 F. 2d 308 (C.A. 2), where rights with a value of $12,255 at the date of issuance were sold for $13,728.04. The sales proceeds, to the extent of the original value of the rights, were treated as dividend income and the additional $1,473.04 as capital gain attributable to the sale of the rights.

Section 1.346–1(a)), although a lesser distribution would generally be taxable at ordinary rates as a dividend.

Section 355 is an analogue of the partial liquidation provisions. It is addressed to, in the Second Circuit's words (R. 290), "only complete, and not partial divisions" of a corporation. It requires the same sort of contraction, or "break-up" (S. Rep. No. 781, 82d Cong., 1st Sess., p. 58), of the original corporate enterprise as a partial liquidation. The principal distinction—and the one that justifies tax-free treatment under Section 355—is that "solely stock or securities" rather than property is "distributed." See our opening brief at pages 35–37. Thus, just as occurs when a distribution is too small to qualify for capital treatment under Section 346, ordinary income rates should be applied here. Since the money Pacific received substantially replaced the assets sold [5] and Pacific parted with only 57 percent of the Northwest stock in 1961, the necessary division and contraction were lacking.[6]

[5] The book value of the Northwest stock in Pacific's hands was less than $16 per share, since it reported a gain on the sale. (R. 248.) Consequently, after exercise of the rights, Pacific's books showed greater assets than when it held the Northwest stock. This too shows that there was not a contraction of the Pacific enterprise.

[6] Taxpayers claim that difficulties under State law were the principal motivation underlying the cash consideration. The theory is that the diminution of the capital structure of Pacific resulting from a distribution of Northwest stock without consideration would have been of questionable propriety under California law (R. 240).

This means, however, on taxpayers' own approach to the case, that State law barred the required contraction; there is of course no justification for relaxing a federal tax statute to

2. When they do turn (Br. 52) to the language of Section 355 (a)(1)(A), taxpayers rely (Br. 52–58) on the statement in *Palmer* v. *Commissioner*, 302 U.S. 63, 69, that "a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property". They argue that it is "self-contradictory" for the Ninth Circuit and the Commissioner to find a distribution "with respect to stock" for purposes of the dividend provision of Section 301 and still hold there is no distribution with respect to stock for purposes of Section 355.

In their analysis, taxpayers have chosen to ignore the other half of the sentence in *Palmer* to which they refer. The unmentioned words are: "such a transaction does not necessarily fall within the statutory definition of a dividend." 302 U.S. at 69. And this language is the heart of the matter. As *Palmer* holds, there is no dividend—*i.e.,* no "distribution * * * with respect to * * * stock" under Section 301—if corporate property is sold to shareholders at fair market value.

There is such a "distribution * * * with respect to * * * stock" only when the sale is a "bargain"—the price is less than value. In that circumstance, which is

provide relief from federal tax consequences flowing from the State scheme of regulation.

(State law was never thought a complete barrier to a spin-off, and the Tax Court was not wholly persuaded that these difficulties were real obstacles (R. 240). The record repeatedly shows, moreover, that the overriding purpose of the cash consideration was to finance substantial past and projected expansion of the California operation (R. 239–240, 49, 87–93, 108–109, 128–132).)

the present case, the item "distributed" is the value of the "bargain," measured by the spread between the price and value.[7] Rights representing the bargain—as were distributed in this case—are clearly a "distribution of *property*" (emphasis supplied) that Sections 301 and 316 make taxable as a dividend. The rights are just as obviously not "solely stock," which is what may be distributed tax-free under Section 355. "The situation is the same as if [Pacific] had sold the [Northwest stock] to strangers [at $26] and then distributed to its stockholders an amount of cash equal to that 'spread.' " *Choate* v. *Commissioner,* 129 F. 2d 684, 687 (C.A. 2). This conclusion is amply supported by authorities, such as *Helvering* v. *Southwest Corp.,* 315 U.S. 194, *Commissioner* v. *LoBue,* 351 U.S. 243, and Section 317(a) of the 1954 Code, which we analyze at pages 23–29 and 46–49 of our opening brief.[8]

[7] There is nothing to the contrary, as taxpayers suggest (Br. 56, n. 15), in the Commissioner's ruling here that "No taxable income will result * * * by reason of holding the * * * rights" and that "The receipt * * * of stock of * * * Northwest * * * upon the exercise of the * * * rights * * * will result in a distribution of property under section 301". These are the results of a computational convenience, see our opening brief at page 49, based on the premise that, as happened here, there would be no material change in the value of Northwest stock between the issuance and sale or exercise of the rights. The Commissioner's position is that there is capital gain or loss, on the sale of the rights in the amount of any such variance. See *Gibson* v. *Commissioner*, *supra.*

[8] The effect on Pacific's earnings and profits would not, as taxpayers maintain (Br. 47), be an anomaly. That effect usually flows by statute when a distribution of corporate property is a dividend under Sections 301 and 316, as it is unless it qualifies for

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3. Taxpayers do not deny that Pacific "sold" the Northwest stock; they contend (Br. 55), however, that the word "distributes" as used in Section 355 includes such a "sale." Their argument seems to be that the word "exchange" is used at one point to describe a "distribution" under Section 355(a)(1)(A), that a "sale" is an "exchange," and therefore that "distribution" includes "sale."

The "exchange" in Section 355 is limited, however, in a way that excludes cash. Section 355(a)(1)(A)(ii), which deals with a spin-off to security holders, requires that "solely stock or securities" of the subsidiary be "distributed" "in exchange for * * * securities" of the parent. These last words would not have been used unless Congress had contemplated that in the exchange the security holder would give up only "securities" of the parent—and not cash or any other item.[9]

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exceptional treatment under Section 355 or some other part of the Code. The same "anomaly" would exist if Pacific had purchased, and then distributed, General Motors shares to its shareholders, even though both Pacific's and General Motor's earnings would remain in corporate solution.

As to taxpayers' apparent suggestion (Br. 46–47) of an improper effect on the basis of the Pacific stock in the hands of those who received rights, see our opening brief at p. 34, n. 11.

[9] The use of the word "exchange" reflects the requirement of Section 355 that such a security holder report gain on a spin-off unless he surrenders securities of the parent in a principal amount equal to or greater than those of the subsidiary which he receives. See our opening brief at page 23, n. 9. If the statute contemplated an "exchange" for cash, Section 355(a)(4) would require the addition of the amount of that cash to the principal amount of the surrendered securities, and the total would be deducted from the principal amount of the securities received in measuring the security-holders' gain.

Taxpayers also say that the use of the word "surrenders" in Section 355(a)(2)(B) shows that "exchanges" and "sales" are generally within Section 355(a)(1)(A). Again the statutory words show a quite different meaning. The surrender is only of "stock" of the parent. This is intended to accommodate the redemptions that mark split-ups and split-offs. This is entirely in keeping with the usual use of the word "surrender" in the Internal Revenue Code—to deal with the circumstance where the shareholder gives his corporation its own stock—and nothing more—upon a distribution of corporate property.

4. Taxpayers never expressly discuss the requirement of Section 355(a)(1)(A) that the parent distribute "to a shareholder" stock in the subsidiary. They seem to allude to it, however, when they assert (Br. 31) that the "purpose was fulfilled" because "Over 95 per cent of the Northwest stock went to the Pacific shareholders, including taxpayers, through the exercise of the rights issued to them." Here, again, taxpayers cannot justify their failure to satisfy the specific statutory language because, in their view, they *almost* achieved the result that the statute demands.

Taxpayers' statistic, moreover, glosses over what really happened. The 95 percent figure resulted only because A.T. & T. received and exercised nearly 90 percent of the rights. Of the minority, over one-third failed to acquire the Northwest stock for which they received the rights (R. 141). This latter number is the proper measure of what is likely to happen when a corporation without a dominant shareholder follows

the same procedure Pacific used here. Such a case must have the same tax consequences as the present one, yet it plainly would not involve the method or results that Congress, in Section 355(a)(1)(A), required of a tax-free spin-off.

5. Nor may it even be said, as taxpayers contend (Br. 43), that Pacific's transaction presented "nothing * * * resembling any bail-out of earnings", by which we assume they mean a dividend distribution (see Br. 30). Each Pacific Shareholder had the option to sell or to exercise his rights.[10] Those who sold received cash. The right sold was an opportunity to share in the part of Pacific's earned surplus that had been transferred to Northwest (see R. 98). Each recipient of the rights had the opportunity to realize cash on his rights, and that cash was directly traceable to part of Pacific's earnings. Thus every shareholder was able to—and a third of the minority in fact did—obtain cash in exchange for giving someone else the right to buy Northwest stock from Pacific. This more than "resembled" a dividend.

[10] Taxpayers urge (Br. 50–51) that the transferability of the stock rights is insignificant because Congress in Section 355(a)(1)(B) indicated its intention not to prevent the alienation of property. But the provision of Section 355(a)(1)(B) states only that sales of the distributing or controlled corporation's stock or securities are to be disregarded, unless made pursuant to a "prior" "arrangement." This hardly means that Congress wanted to encourage sales through a distribution of transferable rights. The use of transferable rights, the sale of which Pacific wished to facilitate (R. 120–121), instead suggests there was here the very sort of "arrangement" Section 355(a)(1)(B) was designed to bar.

III. PACIFIC'S TWO SEPARATE DISTRIBUTIONS CANNOT BE BROUGHT WITHIN SECTION 355(a)(1)(D) BY USE OF THE "STEP TRANSACTION" DOCTRINE

Although Pacific sold only 57% of the Northwest stock in 1961, the taxpayers contend that the requirements of Section 355(a)(1)(D) were met because Pacific sold the rest of the stock in 1963. Section 355(a)(1)(D)(i) requires that "all of the stock" held by the distributing corporation "immediately before the distribution" must be distributed. The only exception is that under Section 355(a)(1)(D)(ii) the requirement is met in certain cases where at least 80 percent of the stock is distributed.

Neither the Commissioner nor the courts could apply Section 355 with reasonable certainty if the statutory requirement for a single distribution were construed so expansively as to encompass the widely separated offerings of the instant case. We do not contend that everything must be done in one instant, or on one day. We do contend that the step transaction doctrine on which taxpayers rely (Br. 63–70) could be invoked to fuse the two Pacific offerings only if the entire distribution were obligated from the outset, and only if the two steps were mutually interdependent so that one would be ineffective without the other. Neither of these prerequisites is fulfilled here.[11]

[11] The Ninth Circuit, in holding that the offerings of Northwest stock were not a single transaction, did not invade the fact-finding province of the Tax Court. There is only the legal question whether the undisputed facts accord with what Section 355 demands. *Dobson* v. *Commissioner*, 320 U.S. 489, 502, on which taxpayers rely (Br. 68) applied to situations "[w]here no statute or regulation controls * * *."

1. Taxpayers seem to recognize that there should have been a commitment to distribute all of the stock (or at least 80 per cent of it) to the Pacific shareholders, but the record does not support their assertion that "there was a fixed intention and a commitment on the part of Pacific to distribute all of the Northwest stock to its shareholders." (Br. 70.) At no point, until the second distribution was made, did the Pacific shareholders have any enforceable rights to the rest of the stock. Examination of the papers used shows that Pacific's management carefully refrained from committing itself.

In the proxy statement asking shareholders to approve the formation of Northwest, Pacific included the "Plan for Reorganization," which stated (R. 108): "Promptly after acquiring the securities of [Northwest] * * * [Pacific] will offer for sale" approximately 56% of the Northwest stock through the issuance of rights. As to further distributions, the statement was that "It is *expected* that within *about* three years" the balance of the stock would be offered "for sale" in *"one or more* offerings." (R. 109; emphasis supplied.) The prices were to "be determined by the Board [of Pacific] at the time of each offering." It was further stated that "It is *expected* that in each case the offering price will be in excess of the par value of the * * * stock." (R. 109; emphasis supplied.)

This "plan," obviously drafted by skilled counsel, left all the choices with Pacific and no legal right to additional shares with its shareholders. No shareholder could compel the sale of any amount of stock, at any time, or at any price. All these matters were left, as

both the Second and Ninth Circuits agreed (R. 281, 330), to the "sole discretion" of Pacific's directors. The only conceivable constraint was "the capital requirements of Pacific" (R. 281), a matter that in itself could be determined only by the discretionary business judgment of the directors.

As Judge Friendly pointed out in his dissent (R. 299–300), a variety of contingencies "might have postponed Pacific's need for funds and consequent further distribution of Northwest stock for many years." See, also, the Ninth Circuit opinion at R. 329. There was no way of determining as of September 1961—or at any other time before April 1963 (see R. 251)—when future offerings of Northwest stock would be made, or at what price.[12]

It was not even necessary that the stock be offered to Pacific's shareholders. All that the plan said was that "it is expected" that such an offering would be made. This was no doubt an accurate statement, but it was not a binding commitment, and deliberately so. No shareholder would have had a right to complain if Pacific had thereafter decided to sell the remaining Northwest stock to the public—or sold part of it and distributed the remainder. Pacific clearly had the right, if its directors so chose, to follow a policy of "indefinite retention" of more than 20 percent of the Northwest stock. Taxpayers in No. 760 acknowledged below (see R. 292) that such a result would prohibit tax-free treatment, which is obviously correct.

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[12] "The Ninth Circuit view (and the dissent in *Gordon*) seems to be the more acceptable interpretation of this provision." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed., 1968 Supplement No. 1), 35.

2. Even if there had been a commitment in 1961 that Pacific would "within three years" distribute the remaining stock to its shareholders, the step transaction theory would still be unavailable because the 1961 transaction had distinct and sought-after business purposes, which were achieved in that year without regard to what happened thereafter. See *American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 405–407, affirmed *per curiam,* 177 F. 2d 513 (C.A. 3). It is clear that each distribution depended on the set of facts existing when it was made. Pacific had a number of objectives. It wanted to decentralize, and it did, in 1961. It sought to give A.T. & T. voting control, and the 1961 offering achieved that result. Pacific needed money—so much and no more; the 1961 rights were exercised so as to meet that need with precision.

What would be done thereafter depended on the facts as they later developed. Pacific did not want future sales prescribed in advance. It wanted to maintain flexibility and freedom in making further offerings, according to its needs as they appeared. No case has applied the step transaction doctrine in such a situation. Nor should the step transaction theory be used except in furtherance of the underlying objectives of the statute. Pacific's 1961 distribution achieved its own purposes, but without the "complete separation" of subsidiary from parent which is the whole basis of Section 355's operation. Since Section 355(a)(1)(D) requires the distribution of "all of the stock" held by the parent "immediately before the distribution", there must be a time when the separation can be fixed. The use of the word "immediately"

suggests that the duration of this period must be relatively short. This case does not call for a final determination of what flexibility is allowed in effecting the distribution.[13] Here the parent had no obligation to act in any definite way at any definite time, and in fact retained the unsold stock for 21 months. Any retention of this sort, without commitment, should take the transaction beyond the ambit of Section 355.[14]

3. Although not expressly acknowledged, the "step transaction" doctrine is an essential premise of tax-

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[13] Taxpayers suggest that it is unreasonable to require that the events of one day be used to measure compliance with Section 355(a)(1)(D). Although they and the Second Circuit call the consequences "staggering" (Br. 64, R. 293), they nowhere explain why it would be any more difficult than the usual corporate practice of paying dividends to those who are shareholders at the close of business on a given day. The statute requires no more than a distribution to shareholders of record as of a given date, for such a distribution would be aimed at a particular and fixed shareholder group. It would make no difference precisely when each shareholder actually received the stock, because his rights would have been defined by the declaration; and it would be permissible for the physical process of distribution to occur "with an expedition consistent with orderly procedure." Cf. Treas. Reg., Section 1.351-1(a)(1). See, also, the Ninth Circuit opinion at R. 333. Here, of course, the evidence shows that Pacific's extended retention of Northwest stock bore no relationship to difficulties encountered in the process of distribution.

[14] Rev. Rul. 57-311, 1957-2 Cum. Bull. 243, does not (see Br. 65) suggest that there may be a split distribution of stock. The focus was on the payment of cash to a shareholder who then paid the amount over to a newly formed corporate subsidiary, all of whose stock he received. The shareholder was merely a conduit for and received no benefit from the money. Here, in contrast, Pacific retained the Northwest stock, and all the resulting benefits, such as dividends, for a substantial period of time.

payers' argument, and the Second Circuit's conclusion, that Pacific's transaction complied with Section 355(a)(1)(A), for rights can be viewed as a distribution of "solely stock" of Northwest only if their issuance and exercise are regarded as merely "Transitory phases" that "add nothing of substance to the completed affair." *Helvering* v. *Alabama Asphaltic Limestone Co.,* 315 U.S. 179, 184–185. But this approach was urged and rejected in *Southwest Consolidated Corp., supra,* a case that was argued and decided at the same time as *Alabama Asphaltic Limestone.* In holding that the transaction did not qualify as a reorganization because the use of warrants meant that there was not the use of "solely voting stock", the Court explained (315 U.S. at 201):

> And it makes no difference that, in the long run, the unexercised warrants expired and nothing but voting stock was outstanding. The critical time is the date of the exchange. * * *

The "critical time" under Section 355(a)(1)(A) is the date of the "distribution". The only event of that day here was the distribution of warrants, evidencing rights to buy Northwest stock. It makes no more difference here than in *Southwest* that once the rights were exercised or expired, only the Northwest stock was outstanding. "'Solely' leave no leeway." *Id.* at 198. When Pacific chose to distribute rights, and sell the stock, it went outside the tax-free route of Section 355.

CONCLUSION

The judgment of the Second Circuit should be reversed and the judgment of the Ninth Circuit should be affirmed.

Respectfully submitted.

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